

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 281

April 23, 1965

RATE CHANGE: APPLICABILITY OF COMPOSITE RATE

Syllabus:

Taxpayer operated on a fiscal year basis and timely filed its return of operations for the income year commencing October 1, 1958, and ending September 30, 1959. In January 1960, a tax clearance was obtained certifying that all franchise taxes have been paid up to and including February 1960. In January 1960, taxpayer was dissolved. The tax rate for the taxable year 1959 was 4% and for the taxable year 1960 it was increased to 5.5%. A refund notice was issued in May 1961, limiting the tax to three twelfths of the combined rate (5.125%) for the taxable year ended September 30, 1960. Subsequently, in June 1961, an additional tax was proposed for the three twelfths period predicated on the same income plus Federal adjustments at the combined rate. Taxpayer protested the proposed additional assessment on the grounds that the period of the taxable year preceding the increase in tax rate should be taxed at the 4% rate since its income on which the tax was predicated was earned prior to the effective date of the rate change.

Should the tax for three-twelfths of the taxable year preceding the rate change be computed at the combined rate or at the 4% rate?

Section 23181 of the Bank and Corporation Tax Law imposed an annual tax upon every corporation doing business within the state. Such tax is according to or measured by net income for the next preceding fiscal or calendar year.

As some corporations report on a calendar year basis and others on a fiscal year basis, some adjustment is necessary if changes in the rates are to apply equally to all corporations. Section 24251 accordingly sets forth a procedure whereby both fiscal year and calendar year corporations will be treated with substantial equality.

Here substantially as under section 105 of the Federal Revenue Act of 1932, when the rates applicable to calendar year corporations, for one calendar year, differs from the rates applicable to calendar year corporations for the second calendar year, the taxes for fiscal year corporations, whose fiscal years are partly within both such calendar years, shall be computed partly under the old law and partly under the new law in the proportion which the number of months in each of the two calendar years bears to the entire fiscal year which falls partly in both of such calendar years.

Section 18, Statutes 1959, Chapter 1127, provides in part that "The provisions of this act effecting changes in the computation of taxes shall be applied in the computation of taxes for all income years ending after December 31, 1958," further that "Banks and corporations whose income year began prior to January 1, 1959, and ends on or before November 30, 1959, shall compute their tax by applying the rate in effect as December 31, 1958, and the rate provided for by this act on and after such date, to their net income for the entire year in accordance with the method prescribed by section 24251."

Section 23041 defines the term "taxable year", for franchise tax purposes, as the calendar year or the fiscal year for which the tax is payable. Section 23042 defines the term "income year", for franchise tax purposes, as the calendar year or the fiscal year upon the basis of which the net income is computed.

In view of the above the effective date provisions mean that calendar year corporations shall pay taxes at an increased rate for the taxable year 1960 and fiscal year corporations shall pay a part of their 1959-1960 tax at an increased rate. Since dissolution of subject corporation occurred during a portion of its fiscal year preceding the effective date of the rate change a question arises as to whether or not section 24251 is applicable.

Section 23332 provides in substance that a dissolved taxpayer shall pay a tax only for the months of the taxable year preceding dissolution according to or measured by the lesser of the following:

- (a) net income of preceding year.
- (b) Percentage of net income, i.e., ratio which months of tax year preceding dissolution bears to months of income year.

The word month, for franchise tax purposes, means a calendar month; however, in the application of the commencing corporation and dissolution provisions this Board construes a fractional part of a month as a full month if it amounts to more than half a month. Since dissolution herein was effected on the 15th day of a 31-day month the January period is disregarded.

Under the (a) computation of section 23332 the tax for the fiscal taxable year ended September 30, 1960, is measured by the net income disclosed by the return for the income year ended September 30, 1959. The tax for the entire taxable year at the composite rate of 5.125% amounts to \$11,390.16. Since dissolution occurred on January 15, 1960, it is necessary to prorate said tax on a 3/12ths basis which reduces the tax payable to \$2,847.54. Under the (b) computation of section 23332 the percentage of net income on the prescribed ratio basis, is \$55,561.76 (3/12ths or 25% of \$222,247.03). At the combined rate the tax amounts to \$2,847.54 and at the 4% rate the tax amounts to \$2,222.47 or a difference of \$625.07.

The composite rate is an administrative expedient under section 24251 to reduce the number of computations otherwise necessary to determine the tax for the entire year due to the rate change. Under the (b) computation of section 23332 it is unnecessary to determine the tax for the entire year since only a percentage of the net income on the prescribed ratio basis is involved in the computation. Further, the legislative reason for the application of section 24251 is lacking since the rate in effect at the time the income was earned and the portion of the tax year in which dissolved both preceded the tax rate change.

We conclude that the tax for the 3/12ths of the taxpayer's tax year preceding 1960 shall be computed at the 4% rate not the composite rate.